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RUEHLP/AMEMBASSY LA PAZ OCT 0759
RUEHPE/AMEMBASSY LIMA PRIORITY 2027
RUEHBR/AMEMBASSY BRASILIA PRIORITY 3810
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TREASURY FOR MEWENS AND MMALLOY
DEPT FOR WHA/EPSC FAITH CORNEILLE

E.O. 12958: DECL: 10/26/2017
TAGS: EPET EINV ENRG ECON PREL EC
SUBJECT: OIL COMPANIES CONSIDERING OPTIONS UNDER ECUADOR,S
99 PERCENT REVENUE SHARING DECREE

REF: A. QUITO 2277

¶B. 06 QUITO 1722

Classified By: DCM Jefferson Brown, Reasons 1.4 (b&d)

¶1. (SBU) Summary: U.S. and foreign oil companies are evaluating whether service contracts could be feasible alternatives to participation contracts in light of the new "99 percent" petroleum revenue sharing decree. U.S. firms City Oriente, Murphy Oil, and Burlington Resources are affected by the decree, as are foreign companies from Spain, Brazil, China, and France. The GOE is also threatening investigations and penalties for noncompliance with the revenue sharing requirements of the 2006 hydrocarbons law, increasing pressure on firms. End Summary.

¶2. (SBU) Following President Correa's October 4 decree requiring a 99 percent share of extraordinary petroleum revenues for the State (ref A), foreign oil companies met privately with Petroleum Minister Chiriboga October 8. Chiriboga reportedly defended and justified the new decree, and formally presented firms with the option of converting to service contracts. For the most part, companies have kept quiet while studying this option to evaluate its feasibility (all have previously stated the 99 percent rule would put them out of business).

¶3. (C) Several key concerns exist with regard to service contracts. Companies have already committed huge sums in investment, and the GOE would need to compensate them for the unamortized portion of those sunk costs. In addition, the GOE would be taking on the financial risk for future operations, which could be substantial (although it claims that since most of the wells are already operational, this risk would be small) -- part of the reason the GOE encouraged companies to switch from service to participation contracts years ago when prices were low. Finally, oil companies may not be willing to operate for solely a fixed fee (without the possibility of high profits) for the long term, particularly given opportunities elsewhere.

U.S. Firms Affected

¶4. (C) U.S. firm City Oriente is the smallest of the petroleum operators in Ecuador (producing approximately 3,000 bpd) and is the last remaining U.S. operator. It claims that it would barely be profitable under the 2006 amendment to the hydrocarbons law (ref B), which requires companies to share at least 50 percent of extraordinary revenues with the State, and as a result it sought international arbitration and has not paid the GOE the 50 percent share. City Oriente asserts it would suffer large losses under the new 99 percent requirement and simply could not operate. A service contract would have to take into consideration City Oriente's unamortized investment costs, which the company reports are about $86 million. After two meetings with the State commission in charge of renegotiating contracts, on October 17 City Oriente proposed a service contract solution that would cover these costs as well as resolve outstanding issues such as its international arbitration claim. The commission responded that it is interested in pursuing discussions based on City Oriente's proposal but noted that a new contract would include only local arbitration (not international arbitration), which City Oriente views as unacceptable. City Oriente plans to continue discussion for a new contract but expects the arbitration issue will continue to be problematic.

¶5. (C) U.S. Murphy Oil's subsidiary Murphy Exploration and Production Company is a minority shareholder (20 percent) in Spanish firm Repsol's Block 16 and two other blocks. Murphy is concerned about the decree; Repsol representatives have said they could not operate under the 99 percent rule. Murphy claims it has an excellent relationship with Repsol and will work with company representatives to seek a viable solution. It expressed concern that if the Repsol consortium seeks a new service contract, the GOE would likely try to limit or
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preclude international arbitration, which would be a big obstacle for Murphy.

¶6. (C) Representatives of U.S. ConocoPhillips-owned Burlington Resources have already left Ecuador and the company has been in the process of trying to sell its assets here. Burlington has one block in force majeure and is a partner in two operational blocks with French company Perenco. The company was in the process of trying to finalize one purchase offer when the decree was announced, stalling the sale. Burlington is working with Perenco to determine what type of contract could be acceptable given the new rules, and plans to then resume its sales efforts.

Other Companies Still Evaluating Situation

¶7. (C) Most companies are keeping very quiet while deciding what to do. Of the Spanish (Repsol), French (Perenco), Chinese (Andes Petroleum), and Brazilian (Petrobras) companies affected, only Repsol has spoken publicly about the decree. Repsol's chairman Antonio Brufau has said he is concerned about the decree and that Repsol would like to remain in Ecuador, but if that is not possible international arbitration would be an option. Privately, City Oriente told us that Perenco is extremely agitated and is considering legal action. Petrobras has a number of other ventures with the GOE (a potential consortium to develop the ITT field; a biofuels pilot project) and is therefore proceeding very cautiously. We have been told privately that Lula wants Petrobras to stay invested in Ecuador in the interest of broader strategic goals, but that the decision will ultimately be made by Petrobras on a basis of business viability. Governments for the countries involved are keeping quiet for the moment, although we heard from the Brazilian Embassy that Foreign Minister Amorim was furious that the decree was issued the same day he arrived in Quito, without any previous warning. The Brazilian Embassy reported that when Amorim expressed his frustration with the decree to President Correa, it seemed clear that Correa had never considered the international ramifications of the action,

having acted based only on domestic purposes. Adding to the confusion, Correa said it could be "negotiable."

Investigation, Oil Embargo Threats Apply More Pressure
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¶8. (C) Complicating matters further, the GOE has been claiming that companies that have not fully paid all of the monies owed under last year's 50 percent requirement (which include Petrobras, Repsol, Andes Petroleum, and City Oriente) could face investigations, penalties, or an embargo of their oil. In particular, the Ecuadorian Attorney General has focused on City Oriente's non-payment and has threatened to nullify its contract (City Oriente has been putting some but not all of the monies into an offshore account until its international arbitration case against the law is resolved). (More details on City Oriente's concerns and Embassy response will be reported septel.) The government also plans to investigate all current contracts for noncompliance in areas such as environmental and community concerns. Most companies consider this to be a GOE strategy to increase pressure on them and gain a better bargaining position for renegotiating oil contracts.

Comment:

¶9. (C) While oil companies consider whether service contracts could be viable, GOE officials have reportedly said the contracts would have to mirror gains under the 99 percent rule. In the meantime, it remains to be seen what impact these changes will have on Ecuador's overall oil production levels. Up through 2005, Ecuador's total petroleum production increased as expanding private sector production more than offset declining Petroecuador production. After Ecuador introduced the 50 percent sharing requirement in April 2006, private sector production has been flat, while

that of Petroecuador and the former Occidental fields has fallen. We have heard that some oil operators are shutting down wells until the current situation is resolved. We have also heard anecdotally from several oil services and consulting companies that their pending contracts with operators have been put on hold, and one oil company has reportedly delayed arrival of new employees.

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